◈ Regional Outlook ◈

FEDERAL DEPOSIT INSURANCE CORPORATION FOURTH QUARTER 1996

In Focus This Quarter

FDIC CHICAGO REGION

■ ***Consumers Declare Bankruptcy in Record Numbers -*** **Despite favorable economic conditions, consumers are declaring bankruptcy in record numbers in the Chicago Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress.** ***See page 3.***

■ ***New Tax Benefits for Owners of Community Banks -*** **The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the sub-chapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.** ***See page 6.***

■ ***Savings Association Insurance Fund (SAIF) Capitalized -*** **After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 was passed to address the serious problems of the SAIF.** ***See page 9.***

DIVISION OF INSURANCE

JOHN D. WEIER, SENIOR REGIONAL ANALYST

JOAN D. SCHNEIDER, REGIONAL ECONOMIST

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Dear Reader,

The first edition of the *Regional Outlook* for the Chicago Region is attached. The *Regional Outlook* is produced by the Division of Insurance (DOI) and is designed to discuss events and trends affecting insured depository institutions in your region. This publication will be produced and distributed quarterly in our effort to share information and work with the Divisions of Supervision (DOS) and Compliance and Consumer Affairs (DCA) to identify emerging risks to insured depository institutions.

The publication contains two sections. The first section, *In Focus This Quarter*, contains several articles which are designed to address significant issues affecting insured depository institutions. The articles are not intended to represent an exhaustive coverage of the subject matter or to be examination guidance. The second section, *Regular Features*, will focus on the Regional Economy, Financial and Commodity Markets, and Banking. This section is not intended to be a substitute for your local or national newspaper but is intended to address some emerging trends and relate them to insured depository institutions.

This publication is regional in focus with individual states and metropolitan areas highlighted where possible. We recognize the importance of local economic information to examiners and intend to address that particular need more thoroughly in another product. DOI will provide periodic economic analyses at the Field Office level in the future.

This publication may be distributed on a wider basis in the future, but it was designed largely with an examiner audience in mind. DOI is very appreciative of the time and constructive feedback members of DOS's and DCA's Chicago staffs provided in the design and testing of the *Regional Outlook.* Many of the suggestions received from those individuals were incorporated into this publication. Your comments on the publication's format and contents, including suggestions for future articles, are welcomed. We also would appreciate your thoughts about the desirability of providing this publication by way of our intra-net homepage, or some other electronic format.

Sincerely,

Arthur J. Murton

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation, 550 17th Street N.W., Washington, D.C. 20429. Visit the Division of Insurance online at http://fdic01/division/doi/. For more information on this publication, please call John Weier at (312) 382-7512 or email him at John D. Weier@DOI@Chicago.

The authors wish to acknowledge the assistance provided by Don Inscoe and Jon Wisnieski of the Division of Research and Statistics in providing some of the data used in this publication. Any errors are the responsibility of the authors. We would also like to thank the employees of the Division of Supervision and Division of Compliance and Consumer Affairs in the Chicago Region for providing feedback used in the development and design of this publication.

Consumers Declare Bankruptcy in Record Numbers

Trend Raises Concerns about Consumer Credit

- **Despite favorable economic conditions, personal bankruptcy rates are rising throughout the Chicago Region.**

- **Indiana stands out among the states in the Chicago Region with the twelfth highest per capita bankruptcy rate in the country.**

- **Credit card charge-offs are approaching recession levels.**

Despite favorable economic conditions, consumers are declaring bankruptcy in record numbers in the Chicago Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress. Both the Senate and House Banking Committees have held hearings on the condition of consumer credit, particularly credit card lending. Much of the concern regarding these trends is due to the fact that bankruptcy filings and charge-offs are rising despite low unemployment and rising income levels.

What Is Occurring in the Chicago Region?

Chart 1 shows the rising trend in consumer loan losses in the Chicago Region as well as the close relationship between these losses and personal bankruptcy filings.

Table 1 (next page) shows the rising trend in personal bankruptcy rates in this Region. Current levels are fairly moderate, compared to other states in the country, with the exception of Indiana which has the twelfth highest per capita filing rate in the nation. Rates continue to grow in the Region despite its low unemployment rate.

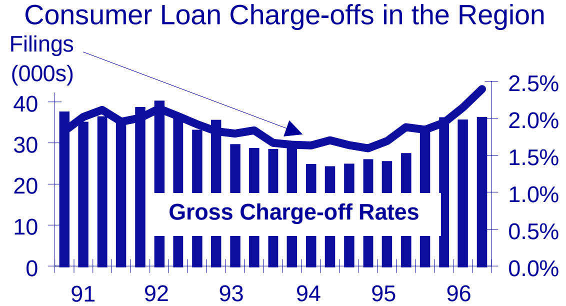
Why Are Consumer Credit Losses Rising in an Expanding Economy?

The emergence of consumer credit problems during an expanding economy is not unprecedented. During the last economic expansion, consumer delinquency and charge-off rates also rose. Consumer debt tends to rise when employment rises because households are more willing to incur debt and banks are more willing to lend. Chart 2 shows that past cycles of rising growth in consumer credit have been followed by rising delinquency rates, even during periods of expansion.

As the expansion closes out its sixth year, American consumers are holding historically high levels of consumer debt -- the ratio of total consumer debt service payments, including mortgage, to disposable personal income is approaching record highs and is currently at 17 percent. High debt levels appear to be the result of several years of economic expansion along with credit card companies' intensive efforts to generate and feed consumers' appetite for credit. Consumers and their lenders are now experiencing the after-effects of this credit expansion.

CHART 1

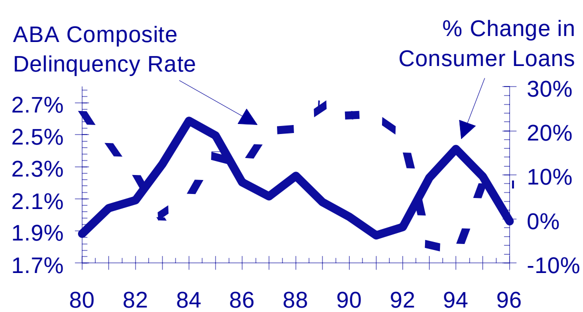
Personal Bankruptcies Correlate with Consumer Loan Charge-offs in the Region



Sources: Administrative Office of the United States Courts and Bank and Thrift Call Reports (RIS). Based on a design by the FDIC's Division of Research and Statistics.

CHART 2

U.S. Consumer Delinquency Rate Tends to Rise After Credit Growth Accelerates



Sources: American Bankers Association and Federal Reserve Flow of Funds

Why Are Bankruptcy Rates Rising?

Nonbusiness bankruptcy filings this year will exceed one million for the first time in U.S. history. This level is 11 percent higher than the peak in the last recession and a 14 percent increase over 1995 filings. A variety of theories have been advanced to explain this trend. These theories include:

- Consumers have overextended themselves.
- Recent changes in bankruptcy laws make it easier to shield assets from creditors.
- Changes in legal practices promote bankruptcy.
- The social and financial repercussions associated with bankruptcy have diminished.

In fact, the trend is likely the result of several factors, many of which are interrelated.

A recent study by ***SMR Research Corporation*** attributes differences in filing rates more to state regulations than to economic conditions. The study found that bankruptcy is driven by the number of and exposure to catastrophic events. For example, in Indiana, SMR attributes a high filing rate to a high divorce rate. The report identifies other factors driving up bankruptcy rates such as:

- inadequate health insurance
- inadequate auto insurance
- a large percentage of self-employed workers
- garnishment of wages
- high debt-to-income ratios

All of these conditions increase consumers' exposure to catastrophic events, such as job loss, that are typically associated with personal bankruptcy.

Of interest to lenders is that some traditional early warning signs of trouble -- such as erratic missed payments or paying off a smaller share of outstanding balances -- are not evident this time. *Some banks are finding that obligations due to them are being wiped out in bankruptcy court on accounts that showed no prior problems.*

Implications for Insured Institutions

These trends have raised concerns about the outlook for credit card lenders. As shown in Chart 3 (next page), credit card charge-offs are approaching levels not seen since the aftermath of the 1990-1991 recession. During that recession, charge-off rates increased sharply. The question arises whether there would be a similar sharp increase in credit card losses during a future recession, driving credit card loss rates to levels well above their previous peak.

This concern is heightened by a number of factors. Consumer debt burdens are at historic highs. Profit margins for the nation's specialty credit card lenders (institutions whose total loans exceed 50 percent of managed assets and whose credit card loans exceed 50 percent of total loans) have rapidly narrowed from a 4.25 percent quarterly return on assets (ROA) in the third quarter of 1994 to a 2.02 percent quarterly ROA in the third quarter of this year. Competitive pressures on pricing and underwriting remain intense, as some companies continue aggressive card solicitations, and

Table 1

Bankruptcy Rates Per Thousand Persons

	1990	1991	1992	1993	1994	1995	3rd Qtr 1996 Annual.	2nd Q 96 State Ranking
Illinois	3.27	3.50	3.48	3.21	3.08	3.48	4.37	17
Indiana	4.41	4.79	4.60	3.86	3.62	3.91	4.81	12
Michigan	2.19	2.55	2.67	2.36	2.21	2.47	3.18	31
Ohio	3.61	3.96	3.61	3.01	2.75	2.99	3.77	26
Wisconsin	2.00	2.29	2.18	1.92	1.92	2.27	2.93	38
United States	3.12	3.46	3.52	3.15	3.00	3.33	4.19	NA

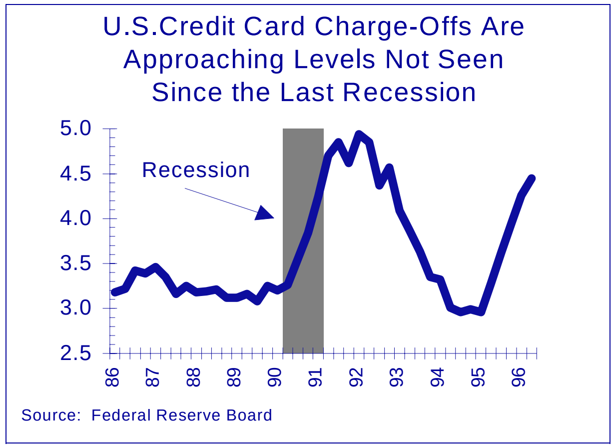
Source: Bankruptcies - Administrative Office of the United States Courts
Population - Census Bureau

there are few signs of any slackening of price competition. A sharp rate cut for AT&T credit cards, one of the largest credit card lenders, is a recent salvo in this price competition. *Lenders also place great reliance on credit scoring models, models that have not yet been tested in a recession* and, according to a recent Federal Reserve survey, appear overly optimistic in almost two-thirds of the banks surveyed.

Other factors mitigate these concerns to some extent. Pricing of credit card loans has traditionally built in a margin of comfort for high and volatile losses. Loan portfolios are diversified with many small loans to individuals. There are preliminary indications that lenders and borrowers are retrenching to some extent. Consumer credit growth slowed from over 14 percent in both 1994 and 1995 to an annualized rate of 8 percent (seasonally adjusted) for the first ten months of 1996. In the Federal Reserve survey just mentioned two-thirds of banks reported raising the score an applicant must achieve to qualify for credit, and one-third reduced credit limits for existing customers.

Generalizations about the outlook for credit card lending are difficult. Trends that describe the industry on average may not hold true for particular institutions.

CHART 3



Performance is likely to vary substantially, with results depending on the risk management practices and underwriting standards of each institution. Given the trends outlined above, credit card lending practices appear worthy of continued close attention by bankers and regulatory agencies.

Diane Ellis, Senior Financial Analyst

New Tax Benefits for Owners of Community Banks

Subchapter "S" Benefits Now Available

- **Potential benefits are substantial. A layer of tax expense has generally been eliminated.**

- **Eligibility is restricted and requires care to maintain.**

- **While no application is required to the banking agencies, the new tax structure has supervisory implications.**

- **The new tax structure has some potential drawbacks.**

Introduction

The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.

Eligibility Is Restricted

The new law allows, for the first time, financial institutions including banks, thrifts, and holding companies to elect subchapter "S" status if they meet several criteria. *The most important of these requirements are that the company not use the reserve method of accounting for bad debts for tax purposes, and that it have 75 or fewer eligible shareholders.* All shareholders must consent to the subchapter "S" election and the IRS must consent to any change in the tax accounting for bad debts. To be able to receive the benefits for tax year 1997, institutions therefore may need to act quickly since changes in either of the above areas may be time consuming.

Industry observers have suggested that over 1,000 banks nationwide will make the Subchapter "S" election.

Reserve accounting for bad debts for tax purposes is an issue affecting only smaller institutions. Currently, reserve accounting is allowed only for those thrifts and banks under $500 million in assets that are not part of a group with more than $500 million in assets. To elect the new tax status, the subchapter "S" company will need to make the accounting change to the specific charge-off method for tax purposes. Presumably, the IRS will not object to any such change, which can delay deductions and increase taxable income, and will allow the change to be effective as of the beginning of the tax year.

In relation to shareholder eligibility, ownership of subchapter "S" corporations is limited to individuals, estates, and a few types of trusts. At present, certain shareholders, such as corporations, Employee Stock

Table 1

Number of Banks with Under $100 Million in Total Assets

	National	Non-Member	State Member	Total
Illinois	124	378	41	579
Indiana	13	68	16	103
Michigan	19	57	19	95
Ohio	47	58	29	151
Wisconsin	30	199	30	269
Total	233	760	135	1197

Source: Preliminary Bank Call Reports as of 9-30-96

Ownership Plans (ESOPs) and other stock bonus plans, may not hold shares in subchapter “S” corporations. Once the subchapter “S” election is taken, the corporation and its shareholders must take care to continue to meet all eligibility requirements or risk losing the tax benefits.

Number of Eligible Institutions

While exact figures on the number of eligible institutions are not available, the number of small banks may provide insight into where the tax election may be seen. As Table 1 (previous page) shows, there are about 1,200 banks in FDIC’s Chicago Region with under $100 million in assets. Table 2 shows there are over 700 with under $50 million in assets. It is expected that a large percentage of these companies would meet the eligibility requirements. Industry observers have suggested that over 1,000 banks nationwide will make the Subchapter “S” election.

Benefits to Shareholders

The tax benefits of the “S” corporation are similar to those of a partnership. The earnings of the corporation generally are not taxed at the corporate level but pass directly to shareholders’ personal income. *As such, cash distributions to shareholders are not subject to an additional layer of taxation, which results in a reduction in overall taxes.* Shareholders remain liable for personal taxes on their proportionate share of the corporation’s taxable income. Distributions formerly paid directly to the IRS by the institution would generally be made to the shareholders, providing them with the funds to pay income taxes on their share of the corporate income. An interagency letter, FIL-91-96 dated October 29, 1996, notes that these distributions will be treated as dividends by the regulatory agencies.

Adding value and flexibility to the “S” corporation structure is the ability to wholly own other “S” corporations. These rules allow holding companies and their bank or savings association subsidiaries to be “S” corporations.

Other Tax Liabilities

For bank or thrift companies that elect to convert to “S” corporation status, there are potentially some other corporate tax liabilities for unrealized gains accumulated through the date of conversion. As an example, should the fair market value of all company assets exceed the adjusted tax bases of these assets, there may be some corporate tax liability if any assets are later sold. Assets held on conversion date and sold within the next ten years require a calculation for “Built-in Gains Tax” (BIG tax) to determine any tax at the corporate level.

Supervisory Implications

While an application to bank regulators is not required for this tax election, there may be a rise in various “phantom bank mergers” or change-in-control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

Table 2

Number of Banks with Under $50 Million in Total Assets

	National	Non-Member	State Member	Total
Illinois	65	265	17	372
Indiana	6	36	4	49
Michigan	9	24	6	39
Ohio	30	36	18	93
Wisconsin	15	126	15	160
Total	125	487	60	713

Source: Preliminary Bank Call Reports as of 9-30-96

Shareholders may enter agreements that place limits on their ability to sell their stock. In addition, the mechanics of a conversion will require some special expertise for the bank in tax law and accounting. The change from the reserve method to the specific charge-off method for bad debts or the existence of net operating losses may present unique circumstances for each institution.

Bank portfolios also may undergo changes prompted by shareholders' requests. An example might be increased purchases of tax-free securities to meet the desires of shareholders for more tax-free interest. Another may arise from a tendency to remove accumulated earnings to pay personal taxes as the corporation generates earnings. This could place a strain on capital in situations where growth is strong or delinquent assets are rising.

Other Drawbacks

To receive the benefits of the subchapter "S" election, the institution will need to meet all the eligibility requirements for every day of the tax year. Furthermore, the IRS has not yet resolved all the tax issues related to the subchapter "S" election on the part of financial institutions. Specific guidelines from the IRS are expected by year-end 1996 which may affect an institution's decision to elect subchapter "S" status.

The states of Connecticut, **Michigan**, New Hampshire, New Jersey, Tennessee as well as the District of Columbia do not recognize the federal subchapter "S" election. Therefore, these jurisdictions do not allow the pass-through benefits of the "S" corporation for the applicable state or district taxes.

Subchapter "S" institutions remain under the same capital adequacy standards and dividend restrictions as other institutions. However, there are times when it may be difficult to maintain the subchapter "S" status. An example would arise when an institution needs to raise capital to meet Prompt Corrective Action (PCA) guidelines. *To meet the IRS requirements for subchapter "S" election while raising the necessary capital, current shareholders may have to be the primary source of new capital.* The ability to raise additional capital by attracting new eligible shareholders may be difficult because the total number of eligible shareholders must remain 75 or fewer to preserve the "S" status. Furthermore, no new classes of stock may be issued. Violation of any of these criteria would result in the loss of the subchapter "S" status and reversion to regular corporate tax rules.

Distributions to shareholders are covered by similar restrictions for subchapter "S" corporations as for regular corporations. However, one possible new twist is that, in some cases, the tax liability payment for shareholders may be due before distributions are funded from the institution. However, this is considered similar to pressures brought by shareholders in other corporations when they require dividend payments to fund debt payments on stock loans.

There may be a rise in various "phantom bank mergers" or change in control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

New Value for the Community Bank Charter

Overall, this newly legislated tax break for closely-held financial institutions may invigorate the value of the community bank or thrift. However, it also adds a new "wrinkle" in the complexity of the examiner's job. While consolidation trends can be expected to continue at larger companies, the new tax benefits available for closely-held institutions add a new incentive for the survival of community banks and thrifts.

Ronald L. Spieker, Chief,
Depository Institutions Analysis Section *

For More Information

Subchapter S Election for Federal Income Taxes. FIL-91-96.

* Extensive review and comments were provided by Robert F. Storch, Chief, Accounting Section of the Division of Supervision.

Savings Association Insurance Fund (SAIF) Capitalized

FDIC Lowers Assessment Rates

- **SAIF was capitalized through a $4.5 billion special assessment. Almost 600 banks and thrifts in the Chicago Region will pay $890 million of this total.**

- **Bank Insurance Fund (BIF) members will bear part of the cost of the Financing Corporation (FICO) bonds beginning in 1997.**

- **The special assessment negatively affects 1996 operating performance, but earnings prospects are greatly enhanced by a proposal to lower future SAIF assessment rates.**

Why Was Action Needed?

After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 (Act) was passed to address the serious problems of the SAIF.

The difficulties facing the SAIF were substantial and demanded a solution. They primarily fell into the following areas:

- SAIF was undercapitalized and there was concern that one large, or several sizable, thrift failures could quickly deplete the fund balance. Its balance was $3.9 billion, or 0.55 percent of insured deposits, on June 30, 1996, well below the target reserve ratio of 1.25 percent of insured deposits.

- Over 45 percent of SAIF assessments were being diverted from the SAIF to pay off FICO obligations arising from the thrift failures of the 1980s.

- The SAIF assessment base continued to shrink, with a 22 percent reduction noted from year-end 1989 to June of 1996.

- A disparity between SAIF and BIF premiums created strong economic incentives for institutions to transfer SAIF-insured deposits to affiliated institutions insured by the BIF, contributing to the shrinkage in the SAIF assessment base.

Over 60 percent of the Chicago Region's institutions paying the special assessment posted a quarterly net operating loss for the third quarter of 1996 ...

Table 1

Chicago Region Institutions Affected by SAIF Special Assessment							
# of Institutions Affected and Total Assessment by Type	Mutual	Savings Banks	S&L	State Member	National	Non-Member	Total
Illinois	52	43	47	3	20	21	186
Indiana	8	47	21	0	6	11	93
Michigan	0	24	2	5	3	13	47
Ohio	26	42	90	6	30	4	198
Wisconsin	23	14	14	5	8	7	71
Total	109	170	174	19	67	56	595
Assessment ($000's)	88,774	519,667	147,825	20,457	98,954	15,068	890,745

Source: Derived From Early estimates of the FDIC's Division of Finance.

What Significant Actions Were Taken?

Special Assessment: In order to address the immediate problems, *the Act required the FDIC Board of Directors to impose a special assessment of approximately 65.7 basis points on SAIF-member institutions*. The special assessment was designed to increase the fund's level to 1.25 percent of insured deposits effective October 1, 1996. In determining the amount, the Board:

- Exempted weak and other specifically defined institutions from paying the special assessment.

- Decreased by 20 percent the amount of SAIF-assessable deposits against which the special assessment will be applied for certain Oakar and other institutions. (An Oakar institution is a member of one insurance fund that has acquired deposits insured by the other fund. The acquired deposits retain coverage under the seller's fund.)

Early estimates are that there will be fewer than ten exempted institutions in the Chicago Region. This number of exempted institutions is small compared with the estimated 590-600 institutions in the Region that paid about $890 million to the SAIF in November. As Table 1 (previous page) indicates, the special assessment affects more than just thrifts. This is due to the substantial number of banks that have acquired SAIF deposits through acquisitions or branch purchases over the last few years.

Table 2

Summary of 1997 Assessment Rates *			
1997 Adjusted BIF & SAIF Schedule			
Capital Group	Supervisory Subgroup A	Supervisory Subgroup B	Supervisory Subgroup C
1	0	3	17
2	3	10	24
3	10	24	27
Exempt Institution SAIF Schedule			
1	23	26	29
2	26	29	30
3	29	30	31
FICO Annual Rates			
BIF Institutions		SAIF Institutions	
1.30		6.48	

* Cents per $100 of Domestic deposits

Source: FDIC's Division of Insurance

FICO Costs: The recently enacted legislation also addressed another legacy of the problems thrifts experienced in the 1980s -- FICO bonds issued in 1987 to help shore up the former Federal Savings and Loan Insurance Corporation (FSLIC). The cost of financing this debt, about $800 million per year, was a major reason the SAIF had not improved as quickly as the BIF.

The Act authorized FICO to impose periodic assessments on BIF members in addition to members of SAIF that were already being assessed. The FICO charge on BIF-assessable deposits must be one-fifth the charge on SAIF assessable deposits. As a result, *the FICO charge on SAIF-assessable deposits for the first semi-annual assessment period of 1997 will be 6.48 basis points (annualized), and the charge on BIF-assessable deposits will be 1.30 basis points.* (See Table 2.) As necessary, FICO rates will be adjusted on a quarterly basis to reflect changes in the assessable deposit bases for the BIF and the SAIF. Beginning on January 1, 2000, or, when the insurance funds merge, whichever occurs earlier, BIF and SAIF members will share the FICO assessment on a pro-rata basis. (FICO assessments will be paid in addition to the deposit insurance assessments. See discussion below.)

Final Rule to Lower SAIF Assessment Rates: With the SAIF now capitalized by the special assessment, the FDIC Board lowered the rates on ongoing assessments paid to the SAIF. The Board also widened the spread between the lowest and highest rates to improve the effectiveness of the FDIC's risk-based premium system.

The final rule establishes an adjusted SAIF rate schedule of 0 to 27 basis points effective for all non-exempt institutions beginning January 1, 1997. (Since only SAIF-member savings associations must, by law, pay for FICO assessments until the end of 1996, a special interim rate was established for SAIF-member savings associations for the last quarter of 1996.)

As is noted in Table 2, institutions exempted from paying the special assessment will not benefit from the lower SAIF assessment rates. Instead, they will pay according to the 23- to 31-basis point schedule through year-end 1999.

Implications for Insured Institutions

Institutions that are required to pay the SAIF special assessment should have accrued a liability and an offsetting noninterest expense as of September 30, 1996. As a result, many such institutions will reflect much lower operating earnings this year. In fact, over 60 percent of the Chicago Region's institutions paying the special assessment posted a quarterly net operating loss for the third quarter of 1996 primarily due to the special assessment.

Concerns over the short-term financial impact described above are moderated by much brighter future prospects. First, the special assessment is a one-time charge and should not affect future earnings streams of nonexempt institutions. Second, the proposed lower SAIF assessment rates should actually help to boost net income in 1997. Finally, some observers have noted that the resolution of the SAIF's deficiencies should remove uncertainties that may have depressed stock prices of SAIF-member institutions. Over the longer-term, the capitalization of the SAIF and the change in assessment rates also pave the way for a dialogue about a possible merger of the two deposit insurance funds.

John D. Weier, Senior Regional Analyst

For More Information

- SAIF Assessments. FIL-88-96
- Accounting for the SAIF Special Assessment and FICO Assessments. FIL-90-96
- Federal Register 61, No. 201, pp. 53834-53841: Assessments.
- Federal Register 61, No. 201, pp. 53867-53876: Proposed Rules - Assessments.
- Press Release 79-1996 and 63-1996.
- Chairman Helfer's Speeches: July 19, 1996, and October 28, 1996.

Chicago Region's Economy in High Gear

- **The Midwest economy is dominated by manufacturing activity, which is highly sensitive to business cycles.**
- **The Chicago Region is operating near full capacity, with high levels of employment and output along with the lowest unemployment rate in decades. This leaves little room for further robust growth.**
- **The current business cycle expansion is showing some preliminary signs of cooling.**
- **A cyclical downturn would have pervasive effects in this Region. It would be expected to affect credit quality and growth in institutions' cyclically-sensitive C&I, real estate, and consumer lending portfolios.**

Manufacturing Operating at High Level

This Region's economy is dependent on manufacturing to a much greater extent than the nation as a whole. Factory jobs provide 27 percent of labor income in the Chicago Region, or one-and-a-half times the share for the U.S. as a whole.

In turn, *manufacturing output is highly sensitive to business cycles*. Therefore, if and when a cyclical downturn gets under way, the associated slump in factory activity will have pervasive effects in the five-state area. They will extend down to the financial condition of retailers, contractors, and others who borrow from FDIC-insured institutions.

Motor Vehicles and Parts: Sales of autos and light-weight trucks are brisk, nearly 15 million units for the third year in a row. Even so, current demand for some models is apparently being sustained by substantial rebates or financing incentives, which are unusual so early in a new model year.

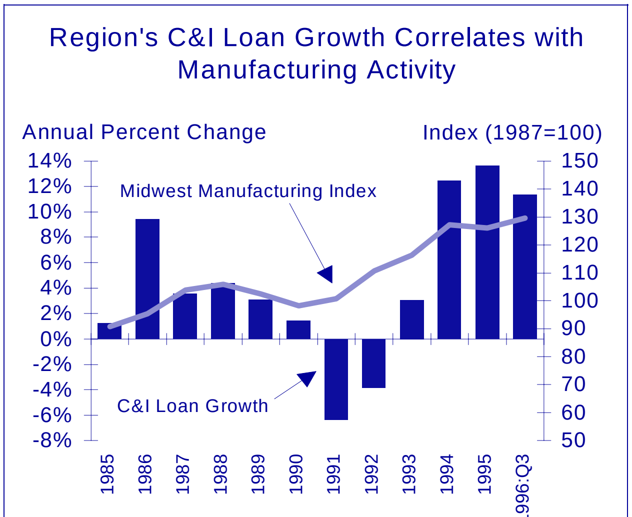
Output may get a temporary boost as GM recoups some production lost during the recent strikes. However, most analysts believe that output is near its peak for this expansion and unlikely to advance much further.

Durable Goods Excluding Defense and Aircraft: The vigorous expansion this sector has enjoyed in recent years may be losing momentum, as indicated by a slowdown in the growth of new orders for durable goods. This indicator gives clues about how production and employment should behave over the next 12 months or so, when orders are being filled.

Excluding the defense and aircraft sectors that are not important in this Region, manufacturers' new orders this fall are running about 7 percent higher than a year earlier. This is a healthy increase but much below the 14.4 percent and 12.5 percent gains in 1994 and 1995, respectively. Thus, the orders data suggest employment and output growth in 1997 will be more modest than in the recent past.

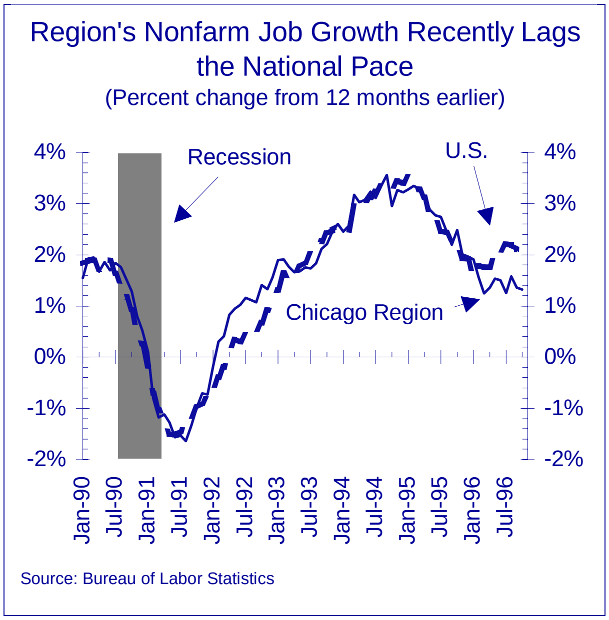
Implications: *Conditions in the manufacturing sector suggest that the current economic expansion may be losing momentum.* This is of interest to bankers in light of the cyclical sensitivity of C&I lending (Chart 1). Both credit quality and loan demand at this Region's institutions can be expected to deteriorate in the event of a recession. Even banks that do not lend directly to manufacturing firms are subject to the effects of developments in the factory sector.

Chart 1



Sources: Bank Call Reports, Thrift Financial Reports (RIS), Federal Reserve Bank of Chicago

CHART 2



Labor Markets Are Tight

Partly as a result of robust demand for manufactured goods in recent years, this Region has experienced healthy growth in employment. Regional job gains matched or outpaced those of the nation as a whole during most of this cyclical expansion. However, this relatively superior performance has faded in 1996: the pace of job growth in the Region both leveled out around a 1.4 percent annual rate and fell noticeably short of the national rate (Chart 2). The slowdown has been most pronounced in Indiana, where the annualized job growth so far this year is a meager 0.5 percent.

Employers' vigorous demand for workers has created tight labor markets in many parts of the Region. In October, the Region's unemployment rate of 4.5 percent compared with 5.2 percent for the nation as a whole. Certain localities are experiencing even lower rates: 1.7 percent in **Madison**, 2.6 percent in the **Ann Arbor** area, 3.0 percent in **Appleton-Oshkosh-Neenah**, and 3.1 percent in the **Chicago** area. *Employers increasingly complain about the shortage of workers*, particularly skilled machinists and workers in the construction and retail industries.

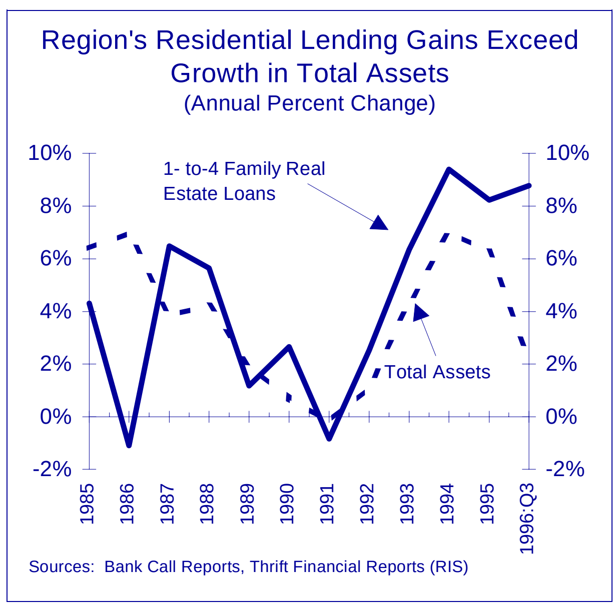
Implications: Tight labor markets are one reflection that this Region is operating near full capacity. This is good news for job hunters but, in some ways, may be a mixed blessing. A tight labor market is a signal of inflationary pressure that is carefully watched by monetary policy makers. When such signals become strong enough the results can include rising interest rates that would affect lending and earning streams of all financial institutions. In addition, higher operating costs and squeezed profit margins for producers could make the Region less attractive as a location for new and existing businesses, calling into question lending decisions based on assumptions of rapid regional growth.

Are Households Peaking Out?

Income and Spending: High levels of employment and income correspond with consumer confidence and expectation levels that are the most positive since the late 1980s. Looking ahead, two factors merit attention. First, income growth slowed to about 4 percent this year and, if the expansion continues to lose momentum, this trend can be expected to continue. *At the same time that income growth is moderating, measures of households' debt burdens are at historic highs and bankruptcies are at record levels*, as discussed in ***Consumers Declare Bankruptcy in Record Numbers***.

Residential Housing: Midwest housing starts and sales slowed recently even though mortgage rates have edged down. October experienced the slowest pace in a year and a half for both housing starts and new home sales. This is consistent with the mature stage of the current business cycle and slower economic growth, as discussed above. Current activity

CHART 3



contrasts with last summer's burst in Midwest housing starts -- to a pace surpassed in only a few months of 1993 and 1994. That temporary spurt was driven in part by weather, not economic conditions: harsh weather in the spring caused a backlog of housing units authorized but not yet started.

Implications: Developments in the household sector are becoming increasingly important to banks in this Region. Residential real estate loans made up 23 percent of insured institutions' assets in the five-state area in the third quarter and these assets have grown faster than total assets throughout the current economic expansion (See Chart 3 previous page). *A recession would have a substantial impact on this business as growth in residential lending would be expected to slow or even turn down.* Financial difficulties experienced by households also would be felt in consumer loan portfolios, particularly in the area of credit card lending.

Revival in Commercial Real Estate

The Chicago Region is following the national trend in that office vacancy rates are trending downward in most markets while rents are on the rise. Behind the lower rates has been a dramatic drop-off in new supply since the late 1980s, combined with growth in office-related employment and the abandonment of some older structures not suitable to updating. Recently, construction has begun to perk up in places, as the past decade's glut of existing space has dwindled. **Columbus** stands out as an active area, despite a recent uptick in office vacancy rates. Other active markets are suburban areas around **Chicago, Detroit**, and **Indianapolis**. A large share of current activity appears to be build-to-suit rather than speculative in nature.

Implications: *Commercial real estate lending in the Chicago Region is on the increase, with exposures substantial relative to capital at some insured institutions.* (See **Regional Banking**) In light of the long time lag between loan approval and occupancy for many commercial real estate projects, lenders may need to give careful consideration to the capacity of a local market to absorb more space. This condition is particularly true when the projects are speculative rather than build-to-suit.

Agriculture: A Good Crop Year After All

The USDA has forecast a record year for agriculture, with $51 billion in net farm income expected in 1996, up from $35 billion last year. As discussed in ***Financial and Commodity Markets,*** weather-related concerns that dominated much of 1996 have been alleviated, and the USDA's mid-November report was favorable for crops important to this Region. *The Region's farmers were not evenly affected, however.* Cattle receipts are forecast to be the lowest so far this decade, and high crop prices boosted feed costs. Thus, financial pressures may continue for beef producers.

Implications: These developments have reduced immediate concerns about banks with lending portfolios dominated by farm credits. *Bankers and regulators are keeping a watchful eye on the response by farm-*

Table 1

Office Vacancy Rates Shrinking in Most Markets

	1991	1992	1993	1994	1995	1996 through 3Q
Chicago	17.0	18.5	19.1	17.5	15.8	14.5
Cincinnati	18.1	17.9	16.7	15.1	14.3	13.0
Cleveland	18.7	20.2	19.7	18.0	16.0	14.7
Columbus	15.4	13.6	10.6	8.0	7.6	8.1
Detroit	19.1	19.7	19.2	18.1	15.5	13.2
Indianapolis	21.7	21.2	19.6	17.5	14.3	12.7
Minneapolis/St. Paul(MN-WI)	18.4	18.9	15.1	11.3	9.5	7.8
St. Louis (MO-IL)	17.5	16.5	15.1	12.5	11.8	10.8
United States	19.0	19.0	17.7	16.1	14.6	13.2

Note: Data cover the metropolitan area and are average for the period.
Source: CB Commercial Property Information Systems

ers to record income levels. Some experts are concerned that high income levels will lead to a recurrence of some of the excesses of the 1970s and 1980s, namely the use of potentially unsustainable cash flows to take on new debt to purchase additional land and equipment.

A possible problem spot revolves around who is ultimately held liable for failed hedge-to-arrive contracts, which generated hundreds of millions of dollars of losses earlier this year. Administrative complaints by the Commodity Futures and Trading Commission (CFTC) in mid-November seem to support farmers' arguments and weaken the position of grain elevators. In essence, the CFTC view is that some hedge-to-arrive contracts were illegal because they were essentially off-exchange futures contracts. Among the grain operators that the CFTC filed suit against are Grain Land Cooperative in Blue Earth, MN; Southern Thumb Co-Op, Inc. in Lapeer, MI; and Buckeye Countrymark, Inc. of Xenia, OH. *This development could weaken -- and may threaten -- the financial viability of some grain elevators*.

Joan D. Schneider, Regional Economist

Financial and Commodity Markets

- **The Treasury yield curve remains steeper than at the beginning of 1996, but it has flattened since July.**
- **The Chicago Region's bank stock indexes have outperformed the S&P 500 so far this year, but they have underperformed the S&P Composite Bank Index.**
- **Evidence suggests that changes in the slope of the short-end of the yield curve may be a good predictor of bank stock performance relative to the broader market.**
- **New yield curve spread futures and options offer an alternative to managing exposures to twists in the yield curve.**
- **Favorable forecasts and a drop in exports have driven grain prices lower.**

Changes in Interest Rates and Bond Values

As reflected in Chart 1, the yield curve has steepened and then flattened this year. The 30-year Treasury yield peaked on June 12 and July 5 at 7.19 percent -- 124 basis points higher than at the beginning of 1996. It has since fallen to 6.40 percent.

To demonstrate the impact that interest rate fluctuations may have had on the market value of a bank's fixed income portfolio, Table 1 presents three types of fixed income securities common to a bank's portfolio: a Treasury bond, a FNMA mortgage pass-through, and a callable FNMA Agency bond. The value of each bond was computed on January 1, July 1, and November 25, 1996. Table 1 lists the percent change in the value of each bond between those dates.

Together the bonds lost nearly 5.27 percent of their value through July 1, 1996, but they recovered 2.74 percent by November. Through the eleven months ending in November, the value of the three-bond portfolio was down 2.68 percent. On an aggregate basis, the Chicago Region's banks fared slightly better. The value of securities holdings for all Call Report filers in the Region declined by only 1 percent for the nine months ending in September. Obviously each institution's investment portfolio performance will vary depending on the types of instruments held and the original acquisition price of each instrument.

CHART 1

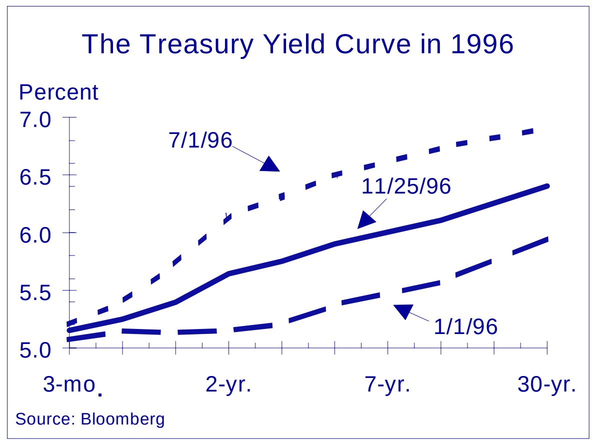


TABLE 1

EXAMPLE OF RECENT BOND PERFORMANCE

	US TREASURY 30-YEAR BOND $100,000 PAR 7.25% COUPON 7.75 YRS UNTIL MATURITY		FNMA MORTGAGE PASS-THROUGH $100,000 PAR 7.5% COUPON 7.59 YRS WAL		FNMA CALLABLE AGENCY BOND $100,000 PAR 7.55% COUPON 7.58 YRS UNTIL MATURITY		TOTAL	
DATE	PRICE	CHANGE FROM PRIOR PERIOD	PRICE	CHANGE FROM PRIOR PERIOD	PRICE	CHANGE FROM PRIOR PERIOD	PRICE	CHANGE FROM PRIOR PERIOD
11/25/96	$107,375	3.84%	$100,280	2.19%	$102,240	2.14%	$309,895	2.74%
7/1/96	$103,406	(7.08%)	$98,130	(3.90%)	$100,100	(4.68%)	$301,636	(5.27%)
1/1/96	$111,281		$102,110		$105,020		$318,411	

SOURCE: Bloomberg

The Chicago Region's Bank Stock Performance

The stock market generally reacts unfavorably to rising interest rates, and reflecting this, the S&P 500 gained only slightly more than 3 percent through July (the latest peak in long-term rates). Since July the decline in rates has propelled the S&P 500 to new record levels, up 21 percent this year. The S&P Bank Index, however, has performed well for most of the year, despite the period of rising rates that occurred during the first two quarters of 1996.

The stellar performance of the money center banks this year -- with Citicorp and Chase Manhattan alone up over 60 percent on the year -- caused the S&P Bank Index to outperform indexes that track the performance of the Chicago Region's banks. The Chicago Regional Bank Index (CRBI), created by the Division of Insurance (DOI), consists of the Chicago Region's 50 members of the American Banker Bank Index, which includes the 225 largest publicly-traded banks or bank holding companies. *The CRBI, which is weighted by total market value of shares outstanding, has gained 37 percent on the year, with performance closely tracking the S&P Bank Index.* The CRBI shares its six largest institutions with the S&P Bank Index: Banc One, Comerica, Fifth Third, Key Corp, National City, and First Chicago. These institutions have averaged a gain of 46 percent on the year, and because of their size, they have a significant impact on the performance of both indexes. DOI's Chicago Region Community Bank Index consists of the Chicago Region's next 16 largest publicly-traded banks or bank holding companies, as reported by the *American Banker*, weighted by total market value of shares outstanding. With a return of 26 percent this year the community banks in this Region have not performed as well as the larger banks. However, community banks still have outperformed the S&P 500.

Do Yield Curve Spreads Provide a Peek at Future Bank Stock Performance?

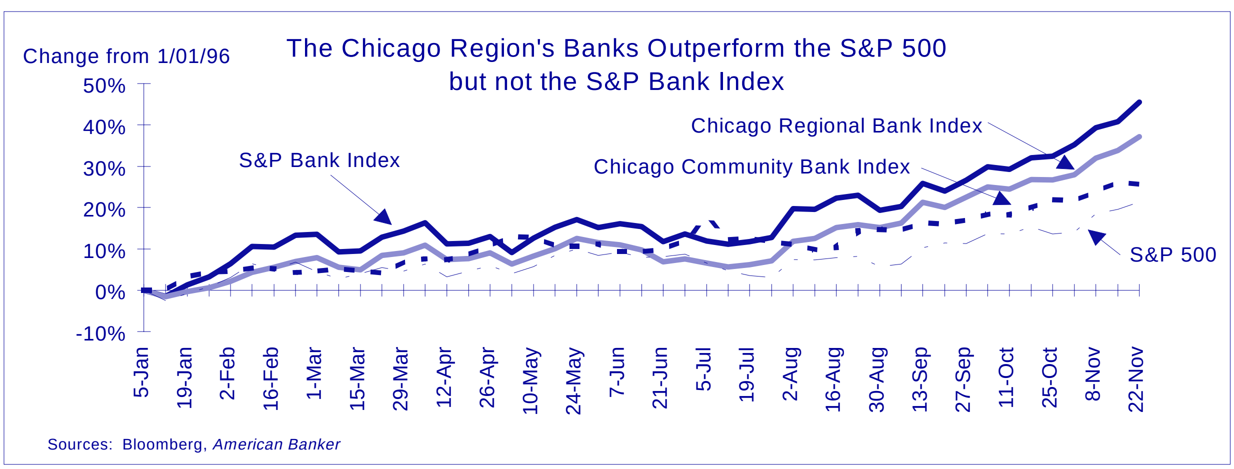
A recent study by Merrill Lynch suggests that the slope of the short-end of the yield curve is a useful predictor of near-term bank stock performance relative to the broader market. For the period 1950 through 1995, the median performance of bank stocks in the study's universe outperformed the broader S&P 500 index 76 percent of the time in the twelve months following a widening of spreads between the 5-year and 3-month Treasuries. In contrast, the median underperformed the broader market 75 percent of the time in the twelve months following compression in the 5-year and 3-month spread. Chart 3 on the following page plots this concept through 1995.

The results of this study are intuitive. A steepening yield curve favors widening interest margins. The opposite is true as the yield curve flattens.

Did the change in the 5-year/3-month spread over the previous year portend the recent strength in bank stocks? Not in this case. For the twelve months ending October 1996, bank stock performance relative to the broader market was strong despite a decline of nearly 200 basis points in the 5-year/3-month spread during the preceding twelve months.

This recent departure from the historical pattern may

CHART 2



have resulted from the market's recognition of widespread cost-cutting and "right-sizing" programs, as well as merger and acquisition activity. Also, bank stock performance has been buoyed by the use of excess funds to repurchase outstanding shares at many institutions, which drives earnings per share higher.

A New Product for Managing Exposures to Yield Curve Twists

Managing earnings exposures to changes in the yield curve typically requires altering cash market positions, executing customized financial derivatives, or contracting multiple positions in exchange-traded derivatives instruments. *Recently, the Chicago Board of Trade (CBOT) introduced new products that may eventually simplify managing this risk -- Yield Curve Spread Futures and Futures Options (YCSF).*

YCSF contracts are structured so the payoff changes only in response to changes in spreads between points along the Treasury yield curve, rather than shifts in the overall level of interest rates. These instruments may provide advantages over hedges involving multiple positions in interest rate derivatives that attempt to isolate spreads along the yield curve. Ten futures contracts with spreads that cover the 2-, 3-, 5-, 10-, and 30-year maturity points were initially approved for trading. Options on these contracts also are traded.

In theory, YCSFs could be used to construct hedges for specific interest-sensitive securities, or more macro hedges based on an institution's overall balance sheet structure. Regardless of how they are used, a great degree of sophistication would likely be needed to construct meaningful hedges. Insured institutions that execute YCSF contracts should be cognizant of the fundamental risks identified in the FDIC's supervisory policy addressing financial derivatives.

Initial trading in the YCSFs has been thin and for some contracts non-existent. A CBOT representative indicated that position holders have been fairly diversified with most volume being derived from speculators and traders for proprietary accounts.

Favorable Forecasts, Fewer Exports Drive Grain Prices Lower

Many market observers were surprised by a mid-November USDA report that projected near-record corn and soybean crops this year. Favorable weather during the late harvest pushed estimated corn production for the 1996/1997 crop year to 9.27 billion bushels -- the third best harvest behind those of 1992 and 1994. *The USDA expects strong corn yields over much of the Corn Belt and record yields in Nebraska, Kansas, and Missouri*. Likewise, soybean production is forecast to total 2.4 billion bushels -- second only to the 1994 harvest.

As expected, prices for corn continued to slide from their summer highs, which were driven by fears of supply shortages, late planting, and late harvest risks. Weaker corn and soybean prices, the second largest

CHART 3

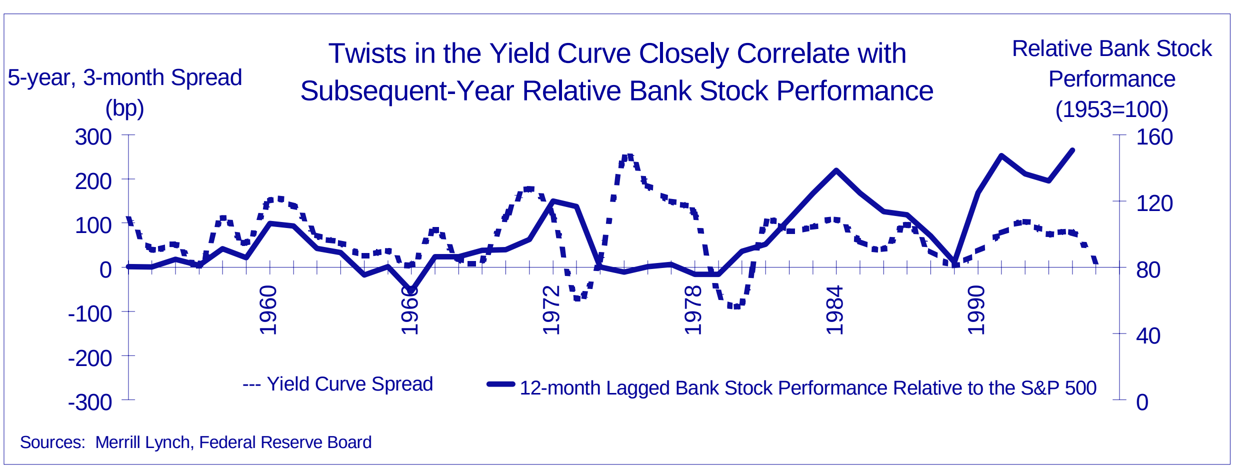
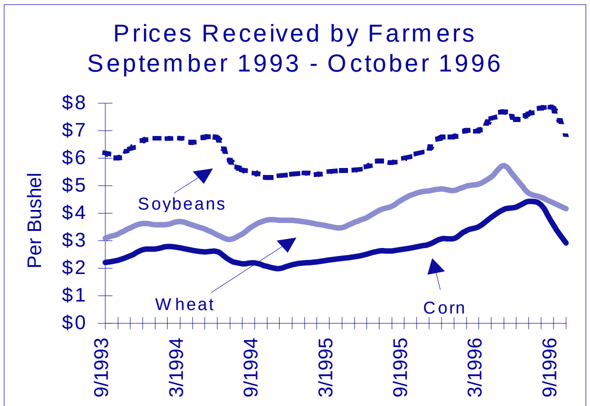


CHART 4



Source: USDA

spring wheat harvest on record, and favorable weather conditions for the recently planted winter wheat crop also have softened wheat prices. (See Chart 4) Further compounding price declines has been a drop in demand from abroad as global competition heightens. *Domestic corn and wheat producers are facing increased production, aggressive marketing, and foreign export subsidies from competitors including Argentina and the European Union*. Soybean exports appear more favorable as Pacific Rim purchases of soybean meal to feed expanding livestock herds accelerate and as South American competitors face lower than expected production.

According to the USDA, average prices for all three crops for the current marketing year are expected to fall from the average of the previous year, but should remain favorable relative to the average price received over the previous five marketing years. Futures markets generally agree with these predictions with some

TABLE 2

MAJOR COMMODITY RANKINGS BASED ON 1994 CASH RECEIPTS

	IL	IN	OH	MI	WI
CORN	1	1	2	3	3
SOYBEANS	2	2	1	4	5
CATTLE	4	4	5	5	2
DAIRY	5	5	3	1	1

SOURCE: USDA

contracts that mature over the 1996/1997 marketing year recently trading approximately 30 percent below their respective contract highs reached earlier in the year.

Provided livestock and milk prices continue their recent ascent or stabilize, declines in feed costs should improve profit margins for livestock and dairy farmers. This is especially good news for cattle operators who faced falling cattle prices and rising feed costs earlier in 1996. Table 2 shows the importance of corn, soybeans, cattle, and dairy for states in the Chicago Region.

The prospect for timely repayment of production loans to the Region's agriculture banks appears good based on the current expectations for operating income. Cash flows for many crop producers also should be supported by the first of seven fixed-support payments under the 1996 Farm Bill.

Allen Puwalski, Banking Analyst
Steven E. Cunningham, Senior Financial Analyst

Current Regional Banking Conditions

- **Regional year-to-date return on assets remains solid; however, third-quarter operating performance at a number of institutions was negatively affected by the SAIF special assessment.**
- **There are signs of a pickup in lending for commercial real estate construction with a significant portion occurring in smaller banks.**
- **While credit quality and loan underwriting standards are generally acceptable, examiner surveys suggest that loan administration may be a concern in about 20 percent of recently examined Illinois and Ohio institutions.**
- **Loan-to-deposit ratios trend higher indicating a structural change that underscores the importance of sound liquidity management practices.**

Generally favorable economic conditions have assisted in maintaining the financial health of the Chicago Region's banks and thrifts. Both balance sheets and examination ratings portray a strong industry. Nevertheless, there are some areas of special interest this quarter. One area, recognition of the SAIF special assessment, was an isolated event and, though somewhat painful, is recognized as the answer to previously identified problems. (See ***SAIF Capitalized)*** Other areas, such as stubbornly rising consumer loan losses and continued concerns over underwriting practices, cause some wariness over where insured institutions may be headed.

Third-Quarter Losses Reflected at a Number of Institutions in the Region

While most banks and thrifts reported solid earnings, operating performance for a number of the Chicago Region's insured institutions was dramatically affected by the recognition of the SAIF special assessment. This third quarter charge, estimated at $890 million, was the primary factor in quarterly operating losses at approximately 370 institutions, with about 100 reflecting year-to-date losses. While both banks and thrifts were affected, the majority of the cost was sustained by savings institutions. As a result, Thrift Financial Report (TFR) filers actually posted an aggregate $92 million loss for the third quarter and recognized only $608 million in net income for the first three quarters of 1996, or an estimated 0.56 percent return on assets based on TFR data. Since the special assessment was a one-time charge, profitability for these institutions is expected to improve next quarter and will likely be further enhanced in 1997 due to lower assessment rates proposed by the FDIC.

Lending Portfolios Show Moderate Growth, Acceptable Credit Quality, but Some Areas of Weakness

The Chicago Region's banks and thrifts recognized an aggregate 11 percent annualized loan growth rate during the third quarter. Not surprisingly, they tended to focus on areas where they already have substantial expertise. For example, thrifts focused on residential lending this quarter, banks under $500 million in total assets showed high growth rates in construction and agricultural lending, and the largest banks concentrated on commercial and credit card loans. On an aggregate basis, commercial loan portfolios increased at a 9 percent annual-

Chart 1

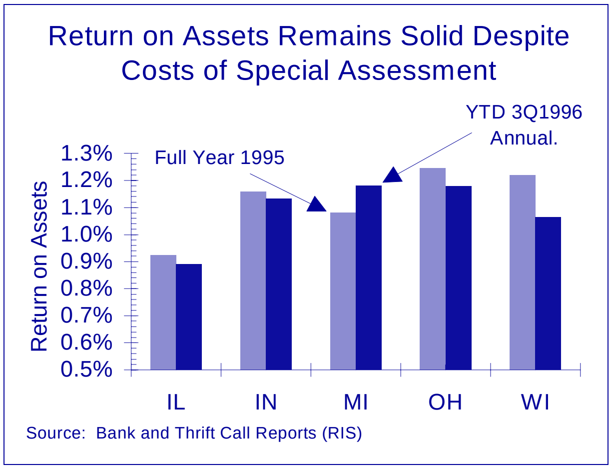
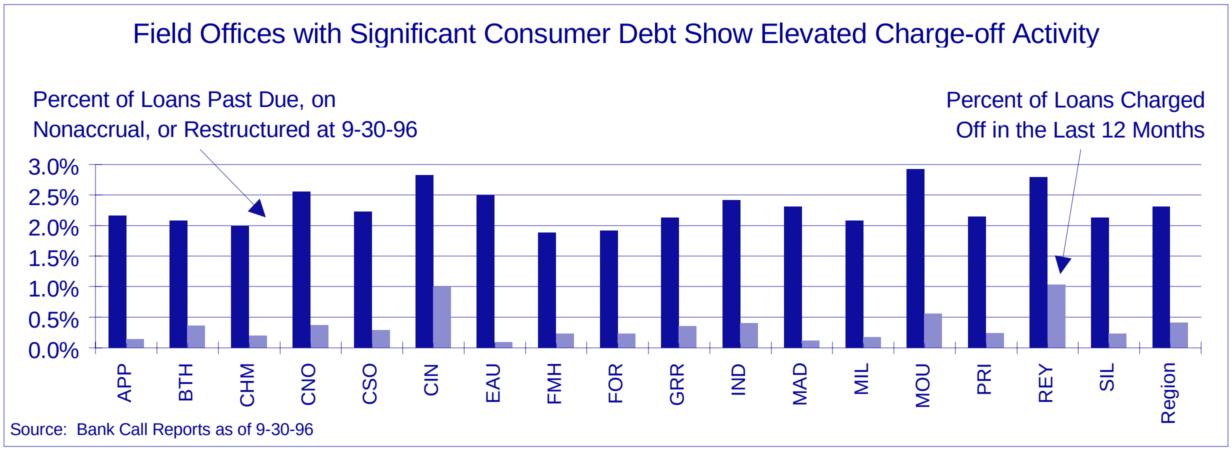
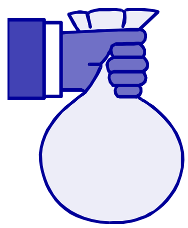


Chart 2



ized rate, with some of the smaller segments of the portfolios, such as home equity and credit card loans increasing at a more rapid pace (23 and 32 percent respectively). This growth appears to be due, at least in part, to consolidation of some multi-bank holding company credit card operations from other areas into one subsidiary bank.



Credit quality for the Region's banks still appears acceptable, with past-due and nonaccrual loan levels remaining at or below 3 percent of loans on an aggregate basis in each field office. Nevertheless, there are areas of concern. Some field offices, especially those with large volumes of consumer debt, have begun to see elevated charge-off activity. In addition, examiners and analysts have noted the following conditions that warrant close attention.

Growth and Concentration of Commercial Real Estate Loans: Declining vacancy and increased rental rates are combining to make construction and commercial real estate lending more attractive to the Region's banks. (See ***Regional Economy***) This has led to increased construction lending and overall commercial real estate loan exposures during the past couple of years. Construction lending was especially strong in smaller institutions (under $500 million in total assets) during the third quarter of 1996, with an annualized 35 percent growth rate noted. Table 1 on the previous page demonstrates that a significant portion of the Region's banks are substantially exposed to lending in this area and, in some cases, may be vulnerable if an over-building situation occurs. Therefore, bankers need to be aware of real estate market conditions so that they can appropriately assess and manage the risk in their portfolios. This type of information can be obtained from many private sources. In addition, the FDIC's Division of Research and Statistics publishes a

Table 1

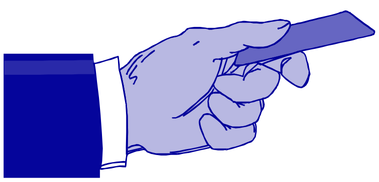
Banks With Construction and Commercial Real Estate Exposures Exceeding 100% of Tier One Capital

	Mutuals	National Banks	Non-Member Banks	State Member Banks	Grand Total
Illinois	4	104	218	45	371
Indiana	4	32	58	11	105
Michigan	0	26	69	16	111
Ohio	11	68	32	31	142
Wisconsin	8	41	139	56	244
TOTAL	27	271	516	159	973

Source: Preliminary Commercial Bank Call Reports as of 9-30-96 comprehensive analysis of the nation's real estate markets on a quarterly basis. They also provide the *Survey of Real Estate Trends,* which provides Senior Examiner opinions on the subject.

Regional Credit Card Lending: The Chicago Region's banks (excluding TFR filers) increased credit card lending during the third quarter by almost $2 billion. Total credit card loans held now approximate $23 billion, with about $150 billion in credit lines available. Unfortunately, on an aggregate basis, the Region's banks registered a high 4.7 percent (annualized) third quarter charge-off rate for such credits, which is up from 4.4 percent last quarter and 3.2 percent for the year ended December 31, 1995. Improvement in this trend may not occur in the short-term, as the Region still reflects past due levels approaching 5 percent in this category.

Given the negative performance trends of the Region's consumer loan portfolios and all the recent publicity over consumer debt levels (See ***Consumers Declare Bankruptcy in Record Numbers***), the growth in credit card exposures warrants continued close attention by regulators and bank management. In that regard, the OCC issued additional guidance to banks during the third quarter, focusing on maintaining prudent underwriting standards and controls. In addition, recent surveys have noted that some institutions are raising cutoff scores on their credit scoring models.

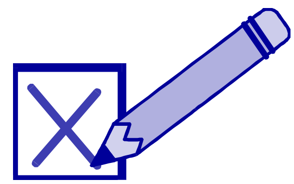


Increased attention may be especially important in Ohio banks, where much of the Chicago Region's credit card activity is centered. Banks in the Ohio field offices hold over 60 percent of regional credit card outstandings. The great bulk of this activity is conducted by affiliates of larger banking and financial services companies. However, exposures are not limited to just one area or larger institutions, as over half the banks in the Region have at least some minimal exposures. Over 40 nonmember banks have exposures exceeding 50 percent of Tier 1 capital.

Loan Survey Information: The Chicago Region's FDIC examiners continue to register some concern over loan administration and competitive pressures. Surveys conducted by the FDIC Division of Research and Statistics during the last six months have shown:

- Risk associated with loan administration was considered "above average" at over 20 percent of examinations conducted in Illinois and Ohio. On a region-wide basis, concern was noted about 18 percent of the time, predominately in institutions that had less than $300 million in total assets.

- Competitive lending pressures were considered "above average" or "extreme" at about 19 percent of examinations both on a regional and national basis.



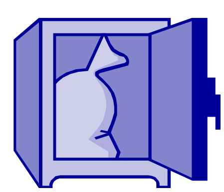
Also of interest is the Federal Reserve's November 1996 Senior Loan Officer Opinion Survey. It disclosed some modest easing of credit standards for middle market and smaller businesses on a nationwide basis.

Loan-to-Deposit Ratios Trend Higher, but Effect on Liquidity is Uncertain

The number of banks with third quarter loan-to-deposit ratios exceeding 75 percent have steadily increased since at least 1993. The increasing number of institutions in this category is not unexpected, as the aggregate loan-to-deposit ratio has historically trended upward during periods of prolonged economic growth.

Traditionally, higher loan-to-deposit ratios have implied a tightening of liquidity. However, funding strategies and loan portfolio compositions have changed at some institutions, making this ratio a less reliable indicator of overall liquidity conditions. These changes include:

- *The increased use of nondeposit funding.* While some of this funding can be volatile, other sources, such as longer-term Federal Home Loan Bank debt, can be fairly stable.

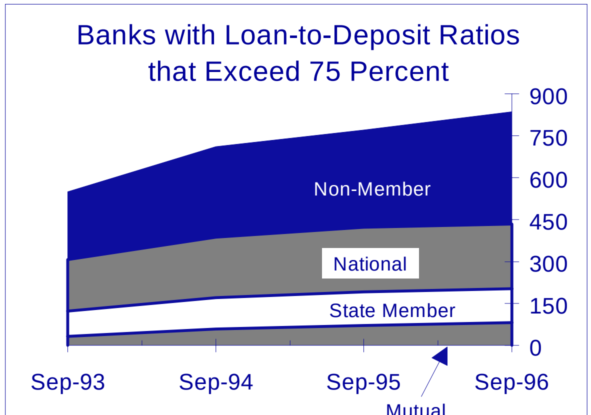


- *Significant investment in consumer and mortgage debt.* The cash flows from the amortization and sale of these instruments, though somewhat difficult to estimate, can be a significant source of liquidity for individual banks. Packaging these instruments into securities also may improve an institution's ability to borrow on a collateralized basis.

Such changes may alter traditional ways of viewing liquidity and increase the complexity of managing this aspect of an institution's operations. Therefore, some bankers may need to reassess their funds management and measurement systems to ensure that they remain appropriate.

John D. Weier, Senior Regional Analyst

CHART 3



Source: Bank Call Reports